Private Bank

Fixed Income Strategy

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Quick update – US and European Preferred Securities

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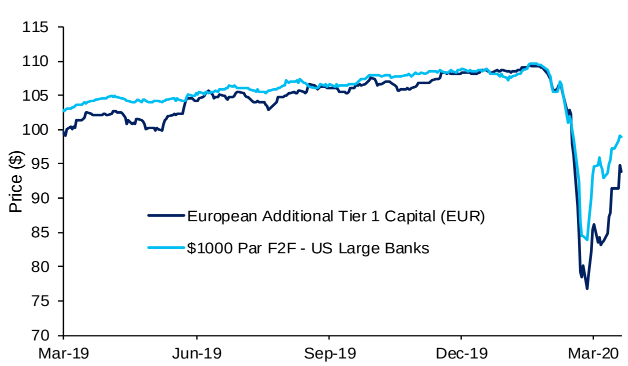
Since we published on Preferreds back on March 25, the US preferred fixed-to-float (F2F) market has gained over 25%. The European Additional Tier 1 (AT1) market has gained 20%. In our view, the massive dislocation, which significantly affected this market last month, has been resolved. A few points are worth highlighting:

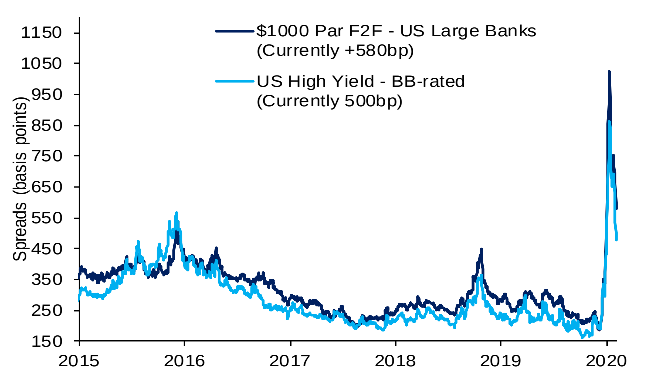
- The average yield (to call) on US F2Fs has fallen to 5.8%, from 10.8% in late March. Average prices have moved from $84 to just under $99. Structures with lower back-end spreads have rallied the most, though these securities sold-off the most. In Europe, average euro AT1 yields have dropped to 8.0%, after reaching 15% (some stocks topped 20%). Average prices are now around $94, from slightly under $80.
- The low hanging fruit appears to be gone, though some structures remain deeply discounted. That said we don't believe we've seen the end of market volatility. Recent US retail sales and industrial production reports were some of the worst on record, or since the end of World War II. As highlighted in the recent CIO Strategy Bulletin, we are expecting a full year drop in GDP of 4.3% in the US, with European economies declining more.
- Q1 bank earnings have been weak, but somewhat expected given the current environment. While trading revenue has been a bright spot, loan books have taken a hit. Indeed, most US banks announced large increases in loan loss provisions to defend against a likely increase in defaults. Based on our expectation of a deep, but short-term economic contraction, these loan losses may not be worrisome. However, if the crisis lingers, loan losses can have larger impacts on net income. Especially coming from the commercial real estate sector.
- The willingness for banks to pay dividends may also remain a source of volatility for the preferred market over the next few quarters. Most developed banks have suspended stock buy-back programs, while European banks have already suspended dividends on common equity. Of course, suspending common dividends leaves preferred shares next in line. For now, we expect the largest, highest quality issuers to continue to pay dividends on their preferred shares.
- **Bottom line**, we remain constructive on the US and European preferred market for longer-term income-oriented investors. Despite the rally, yields remain several hundred basis points higher than a few months ago. However, expected volatility could present better opportunities to add exposures. We would advise creating a list of preferable securities and use periods of market disruption to accumulate exposures. We prefer high quality European AT1 and large US bank structures with wide back-end spreads. We also note that declining market liquidity still remains a factor, requiring patience.

Figure 1. US & European preferred prices have retraced



Source: Bloomberg as of April 16, 2020

Figure 2. Dislocations have closed, but value remains



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Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index.